JUN 9 1942
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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1942.

No. 135

SECOND CAREY TRUST, AN EXPRESS TRUST,
Petitioner,
v.
GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA.

This is a petition for a writ of certiorari to the United States Court of Appeals for the District of Columbia, involving a decision by that Court in the case of *Second Carey Trust, an Express Trust*, v. *Helvering, et al.*, No. 7,865, wherein that Court affirmed a holding of the United States Board of Tax Appeals.

OPINIONS BELOW.

The opinion of the Court of Appeals (R. 95–101) is reported at —— App. D. C. ——, 126 F. (2d) 526, and the opinion of the Board of Tax Appeals (R. 15–34) is reported at 41 B.T.A. 800.

JURISDICTION.

The opinion of the United States Court of Appeals for the District of Columbia was entered March 9, 1942 (R. 95–101), and the judgment of the Court was entered on the same day (R. 102). This petition is made pursuant to Section

240(a) of the Judicial Code (36 Stat. 1157, Sec. 240(a)), as amended by the Act of February 13, 1925 (43 Stat. 938; 28 U.S.C.A. Sec. 347), and within the three months period from the date of entry of judgment in the lower Court as provided by Section 8 of the Act of February 13, 1925, c. 229 (43 Stat. 940, 28 U.S.C.A. Sec. 350).

STATUTES INVOLVED.

The relevant statutes are set out in the appendix to this petition (pp. 19–22).

SUMMARY STATEMENT OF THE MATTER INVOLVED.

On January 19, 1934, A. J. Diffie, W. E. Brown, and H. I. Shanks executed a "Formation and Declaration of Trust" (R. 73–84) in which they designated themselves trustees of an interest consisting of the right to receive one-eighth of seven-eighths of the net proceeds from the sale of oil and gas produced from the Westgate-Carey oil and gas mining lease. The trust was named "Second Carey Trust" and was organized as an "express trust" under Sections 11,820–23 of the Oklahoma Statutes of 1931 (App. 21–22), with office at 905 Kennedy Building, Tulsa, Oklahoma. (R. 62–64, 73, 76.)

The trustees also declared as property of the trust four non-producing oil leases. Said leases were never developed or operated and never produced any revenue. They expired twelve months from their date because of non-payment of rental. (R. 64, 66.)

The material provisions of the trust instrument were as follows:

That the trust estate should be represented by 5,000 units of beneficial interest for which non-assessable certificates of beneficial interest were to be sold, each unit of beneficial interest entitling the owner thereof to a one five-thousandth part of the net income and proceeds derived from the trust estate (R. 77); that said certificates should be transferable

only upon the books of the trust (R. 77); that the trustees should have exclusive power and authority to manage the trust, to receive and collect the income from the trust property, to distribute the income and proceeds therefrom, and to sell and convey any of the trust property with the written consent of the owners of two-thirds of the beneficial units (R. 78); that the trustees were authorized to deduct from the gross receipts all necessary expenses incurred in connection with the management and administration of the trust, including as compensation for themselves five percent of the net receipts from whatever source derived (R. 79) and were required to distribute the net receipts so arrived at equally among the unit holders before the 25th day of the month following the month in which such receipts were received, less a small amount which might be necessary to defray current expenses (R. 80); that neither the trustees nor the unit holders should be personally liable for the obligations of the trust and that the death of a unit owner or the transfer of a unit should not affect the continuity of the trust (R. 81); that the trust should exist for a period of 20 years, but could be terminated at any time upon the written direction of the owners of two-thirds of the beneficial units (R. 78); that the trustees should administer the trust faithfully and diligently and should keep correct records and accounts of all transactions (R. 82); and that, upon the resignation of any trustee, the remaining trustees should name his successor (R. 83).

The trustees sold the 5,000 units of beneficial interest to the public for the sum of $500,000. The expense of selling the units was $100,000 and $400,000 was applied to pay for the interest in the Westgate-Carey lease. (R. 63–64.)

On January 19, 1934, the Westgate-Carey lease was a producing lease and was being operated by the Westgate Oil Company under an agreement with Natural Gas Corporation made prior to January 19, 1934. Petitioner had a minority interest in the lease and had no voice in its management or operation. Its only right was to receive its share of the pro-

ceeds from sales of oil and gas, less its share of the operating expenses. (R. 62–63, 65–66.)

Petitioner has never operated any oil property (R. 64). Its only activity has been the receipt of the net proceeds to which it was entitled and distribution of those funds to its certificate holders (R. 62–63). Petitioner was not consulted as to the operation and management of the Westgate-Carey lease (R. 66). Petitioner has never purchased or invested in any other property or sold any of the property which it owned (R. 24, 64). It has never owned an interest in well drilling and development machinery. It acquired a pro-rata interest in the Westgate-Carey lease operating equipment and through the withholding of its share of the operating expenses by the company operating the lease, petitioner has acquired a pro-rata share in the additions to the lease operating equipment. (R. 24, 63.)

Petitioner filed an income tax return for 1934 as a trust on Form 1040, disclosing therein a net loss for the year. Respondent determined that petitioner was an association, taxable as a corporation. The Board, one member dissenting, and the lower Court affirmed this holding. (R. 10, 29, 34, 99.)

Petitioner's trustees did not own any units of beneficial interest in the trust and had no interest in the trust property; except that they retained for themselves the proportionate part of the net income from the Westgate-Carey lease which was apportionable to the unsold units of beneficial interest (R. 77, Par. Fifth). While the beneficial units were being sold in 1934, the net income applying to unsold units was $48,382.84. The trustees retained only $11,500.00 of this amount and contributed the balance of $36,882.84 to the trust. Said amount did not constitute income to petitioner, but respondent included the amount in petitioner's income for 1934. (R. 68, 91.) The Board questioned whether the amount constituted income but refused any relief on the ground that the issue was not raised in the petition, and the Court of Appeals affirmed. (R. 33–34, 101.) The issue was raised in the petition before the Board in Paragraph 4(b)

(R. 4), which alleges error in treating all cash receipts of the trust as income, regardless of their source.

In its 1934 return petitioner took a deduction for depreciation and depletion in the amount of $35,466.05, based upon cost. The revenue agent was furnished the data to substantiate these deductions but he recommended that no deductions be allowed, not because they were not proper, but because petitioner had not *filed* the substantiating data with the Bureau of Internal Revenue, when advised by its then counsel that to do so might be taken as an admission that it was an association taxable as a corporation. The respondent did not allow any deduction against income to petitioner for depreciation and depletion. (R. 11, 12, 25, 69–70, 90.) The statute provides that a deduction for depletion shall be allowed on the cost or percentage basis, whichever gives the greater deduction. (App. 20, *infra*.) The Board held it was improper to allow no deduction and it allowed a depletion deduction on the percentage basis (27½% of gross income from the property), but did not allow deductions for depreciation and depletion on the basis of cost (which exceed percentage depletion) because of lack of evidence. The Court of Appeals did not allow any further deductions. (R. 30, 31, 100–101.)

Petitioner was required to pay its share of the development expenses on the Westgate-Carey lease in 1934. It did not deduct these expenses in its 1934 return because the return was filed upon the trust basis and showed a loss without the deduction. Respondent did not allow the development expenses on the ground that petitioner failed to elect to deduct them. The Court below did not allow the deduction on the ground that the issue was not raised in the pleadings. (R. 47, 52, 93, 101.)

At the hearing before the Board petitioner's then counsel introduced evidence relating to the formation of the petitioner and the type of activity in which it engaged, in an effort to show that it should be taxed as a trust. He also introduced evidence to show that respondent arbitrarily and erroneously failed to compute properly petitioner's income and tax, even

if petitioner should be held to be taxable as a corporation. (R. 60–72.) He did not prove the proper income and deductions, but proceeded on the theory that petitioner's taxable status would be resolved before other questions became material. Acting on this premise, at the conclusion of the hearing he filed a motion for a further hearing in order to show the correct amount of tax due, if the Board should hold petitioner taxable as a corporation and should find the Commissioner's determination arbitrary, excessive, and erroneous. (R. 14.) The Board held that petitioner was taxable as a corporation and that the respondent's determination was excessive and erroneous in certain respects, but it did not grant a further hearing for the purpose of determining the correct tax liability. (R. 29–30.) Thereafter the Board denied timely motion for rehearing, reconsideration and further hearing (R. 34–39); and a motion to vacate decision, for new trial or further hearing, for additional findings, and to allow amendments to petition with regard to the elimination of $36,882.84 from income and a deduction for development expenses. The requested additional findings and amendments were attached. (R. 40–53.) The lower Court refused to direct a rehearing for the purpose of arriving at the correct tax liability. (R. 99–101.)

Petitioner desires this Court to review the case and decide the question of (1) whether the trust is an association taxable as a corporation; (2) whether the amount of $36,882.84 contributed to the trust was income; and (3), if it is held that petitioner is taxable as a corporation, whether the case should be remanded for rehearing in order to determine petitioner's correct income and tax liability in 1934, including the proper deductions for depreciation, depletion, and development expenses.

QUESTIONS PRESENTED.

The questions presented are:

1. Is petitioner a trust and taxable as a trust, or is it an association taxable as a corporation?

2. Should the amount of $36,882.84 be excluded from petitioner's income, when it was a gift and a contribution to the corpus of the trust?

3. Even if petitioner is an association taxable as a corporation, should the case be remanded to the Board, under the circumstances of this case, to determine petitioner's correct tax liability with particular reference to allowable depreciation and depletion deductions and deduction of development expenses?

REASONS RELIED UPON FOR ALLOWANCE OF WRIT.

1. The decision of the lower Court that petitioner's status as an express trust under the laws of Oklahoma is not binding for taxation purposes, conflicts with the decision of this Court in *U. S.* v. *Cambridge Loan & Bldg. Co.*, 278 U. S. 55. There this Court held that where the income tax act did not define a "building and loan association" (exempted from taxation by the act), the question of whether the taxpayer was a building and loan association must be determined under State law. Here the Revenue Act taxes "associations" as corporations but does not define what an "association" is. Petitioner's status under Oklahoma law must therefore govern its status for Federal tax purposes. Under Oklahoma law, an express trust is held not to be an association taxable as a corporation. *State* v. *Prairie Cotton Oil Co.*, 180 Okla. 608, 71 P. (2d) 988.

2. The decision of the lower Court that petitioner is an association taxable as a corporation is in conflict with the decisions of this Court in *Crocker* v. *Malley*, 249 U. S. 223, *Morrissey* v. *Com.*, 296 U. S. 344, and *Helvering* v. *Combs, et al.* 296 U. S. 365. In those cases this Court held that the essentials of taxability as a corporation include association in an enterprise

for the transaction of business. As appears from the foregoing statement, the owners of the units of petitioner's beneficial interests were not associated together; the certificates were sold to members of the public who did not know the other certificate holders and had nothing to do with the planning or creation of the trust. They did not carry on a business since their only activity was to receive their proportionate share of the net proceeds from the lease.

3. The decision of the lower Court that petitioner was carrying on a business is in conflict with the decisions of this Court in *Higgins* v. *Com.*, 312 U. S. 212; *City Bank Farmers Trust Co* v. *Helvering*, 313 U. S. 121; and with the decision of the Circuit Court of Appeals, Sixth Circuit, in *The Cleveland Trust Co.* v. *Com.*, 115 F. (2d) 481. In those cases it was held that the mere receipt and recording or distribution of income does not as a matter of law constitute doing business. The petitioner's activities during the taxable year were the collection of its share of the net proceeds from the Westgate-Carey lease and the distribution of it to the holders of beneficial interests. The trust instrument required the trustees to distribute the income monthly (R. 80), and gave them no power to hold, reinvest or otherwise dispose of it. The lower Court held (R. 99) that the decision to abandon four non-producing leases was evidence of carrying on business. The Court misconceived the facts. The record shows that petitioner never paid rent on the leases and they expired without having been developed at the end of 12 months from the date of the lease for failure to pay rental. (R. 66.) The trustees had no power to develop the leases, since they were required to distribute all income, and no power to sell without the consent of two-thirds of the beneficial owners. The non-payment of rent certainly can not be considered the doing of business under the aforesaid decisions of this Court, and it is difficult to see how business can be carried on by a decision not to pay rent on undeveloped leases.

4. The refusal of the lower Court to exclude the amount of

$36,882.84 from petitioner's income conflicts with the decision of the Circuit Court of Appeals, First Circuit, in *Rice, Barton & Fales, Inc.*, v. *Com.*, 41 F. (2d) 339, and with that of the Circuit Court of Appeals, Seventh Circuit, in *American Dental Company* v. *Com.*, ——— F. (2d) ———, decided May 15, 1942. The said amount was contributed by the trustees to petitioner without obligation on their part to do so. Under the aforesaid decisions amounts so contributed constitute gifts and are not income (Sec. 22(b) (3), App. 19). The Court's statement that the issue was not raised by the pleadings is clearly erroneous when the issue is comprehended within the allegation that respondent erred in holding all cash receipts to be income, regardless of the source from which derived (R. 4).

5. The lower Court *assumed without proof* (R. 101) that the petitioner's trustees "disregarded" the amount of $36,882.84, which they contributed to the trust, as income upon which they were taxable, and refused to exclude the item from petitioner's income in part on this ground. The trust composed of its beneficiaries is a different entity from the trustees (none of whom were beneficiaries), and it is erroneous to consider their tax liabilities as a unit. Moreover, the revenue agent's report dated August 1, 1936 (R. 91), discussed the item long before the statute of limitations barred assessment against the trustees. If the trustees did not report the amount as income, it may be assumed that an assessment of tax based on the amount was made at that time. It should be observed also that the lower Court made the assumption, that the trustees did not report the amount of $36,882.84 as income, of its own volition and without a suggestion from either party that such might be the fact.

6. The refusal of the lower Court to order a rehearing for further evidence conflicts with decisions of the Circuit Court of Appeals, Fourth Circuit, in *Underwood* v. *Com.*, 56 F. (2d) 67, and the Circuit Court of Appeals, Sixth Circuit, in *Ray W. Torrey Co.* v. *Com.*, 84 F. (2d) 659. In those cases it was

held that where it appears that the income and tax liability as found by the Commissioner or the Board is obviously wrong, it is the *duty* of the Board and the Court to order a rehearing. In the *Underwood* case, the question was whether the salary of a State architect was exempt from taxation, and if not exempt, the amount of his net income. At the hearing the taxpayer failed to prove the deductions to which he was entitled in arriving at net income. The Board held that his salary was not exempt and held all of it to be taxable because of lack of proof as to the allowable deductions. The Circuit Court reversed because the income and tax liability, as determined, were clearly wrong. In this case the evidence establishes that the income and the tax determined to be due thereon for 1934 were excessive, and the Board's opinion shows that petitioner was entitled to additional deductions. This is not a case where the taxpayer merely failed in his proof. Here no proof of correct income and deductions on the corporate basis was offered, due to the theory of procedure held by petitioner's original attorney at the hearing. The Board was requested at three different times, by timely motions, to correct the error and order a rehearing (R. 14, 34, 40). A more complete argument of this point appears in the motion to vacate (R. 40–53).

CONCLUSION.

For the foregoing reasons, it is respectfully submitted that the petition for writ of certiorari should be granted.

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MEMORANDUM IN SUPPORT OF FIRST, SECOND, AND THIRD REASONS FOR GRANTING WRIT OF CERTIORARI.

This memorandum in lieu of a full brief, is submitted to the Court in support of the first, second, and third reasons for allowance of the writ of certiorari.

First Reason:

The provisions of the Revenue Act of 1934 for the taxing of trusts are found in Sections 161(a) and 162(b) (App. 20) which provide that the taxes imposed on individuals shall apply to the income of property held in trust; that the trust income shall be "computed in the same manner and on the same basis as in the case of an individual" and that any amount of income which is to be distributed currently to the beneficiaries shall be allowed as a deduction in computing the income of the trust.

The facts in this case establish that petitioner is a trust created under Oklahoma law and that its property is held in trust by its trustees for the benefit of its beneficial owners. The trust instrument provides that all moneys received from trust properties (income or capital) shall be distributed to the beneficiaries on or before the 25th day of the month following the month in which received (R. 80).

Thus petitioner comes squarely under the law imposing a tax on trusts. Its property is held in trust and it distributes its income monthly, as well as the proceeds from its capital (depreciation and depletion reserves). The Board and the Court, however, held that petitioner is an association taxable as a corporation under Section 801 (a) (2) of the Act. In so doing they disregarded the fact that petitioner is an express trust and is not an association under Oklahoma law.

In *U. S.* v. *Cambridge Loan and Bldg. Co.*, 278 U. S. 55, the question was whether the Cambridge Company was a building and loan association within the meaning of the revenue act exempting such associations from taxation. The United States contended that the company was for all practical pur-

poses a bank. It was held in an opinion by Mr. Justice Holmes that, since the Federal law did not define a building and loan association, the company's status under Ohio law must determine the question. Since it was recognized as a building and loan association in Ohio, it must be so recognized for Federal tax purposes.

Section 801(a) (2) of the Revenue Act of 1934 defines the term "corporation" as including associations, but nowhere does the Act define the word "association." Therefore, applying the *Cambridge Loan & Building Company* decision, it is necessary to look to Oklahoma law to determine petitioner's status. There petitioner is not an association taxable as a corporation.

Petitioner is an "express trust" organized under Sections 11,820–11,823, inclusive, of the Oklahoma Statutes, 1931 (App. 21–22). These sections authorize the creation of express trusts for certain purposes and establish them as entities under Oklahoma law.

By Section 11,820 trustees of express trusts are authorized to do only acts which individuals, as distinguished from corporations, may do. It has been so held by the Oklahoma Supreme Court and an "express trust" is treated as an individual. See *General American Oil Co.* v. *Wagoner Oil & Gas Co.*, 118 Okla. 183, 247 Pac. 99; *Wagoner Oil & Gas Co.* v. *Marlow*, 137 Okla. 116, 278 Pac. 294; *State ex rel.* v. *Douglass*, 185 Okla. 3 (found in dissenting opinion); *New York Casualty Co.* v. *Day*, 185 Okla. 581.

In *State* v. *Prairie Cotton Oil Company* (1937), 180 Okla. 608, 71 Pac. (2d) 988, the State of Oklahoma had taxed the Prairie Company, an express trust, as a corporation under Section 12,369, Oklahoma Statutes, 1931, which provided in part:

> "All corporations organized, existing, or doing business in this state, for profit, other than public service corporations * * *, and other than national banks, state banks, and trust companies, shall be assessed upon the value of their moneyed capital," etc.

The Court, in holding that the company was not a corporation, said:

"The defendant in the instant case is a business trust organized pursuant to Sections 11,820–11,823, Oklahoma Statutes, 1931. It is not a corporation, company, association or joint stock company having powers not possessed by an individual within the purview of Sections 1 and 18B, Article IX, of the Constitution, and is, therefore, not a corporation within the meaning of the tax statutes, Sections 12,369, 12,372, Oklahoma Statutes, 1931. The evidence shows that its affairs are conducted by 3 trustees who employ a manager subject to their own supervision. The trustees are subservient to no one. It is therefore not a joint stock company. *Earlsboro Gas Co.* v. *Brown Drilling Co.*, 175 Okla. 320, 52 Pac. (2d) 730. Aside from the fact that it has a trade name in which it may sue or be sued, it has no rights under the law that an individual does not possess. See *Liquid Carbonic Co.* v. *Sullivan*, 103 Okla. 78, 229 Pac. 561. That fact alone is insufficient to warrant its classification as a corporation. Its property is assessable for taxation in the same manner as that of any individual."

It is thus conclusively shown that under Oklahoma law, an express trust is not an association and is not taxable as a corporation. It is an individual, whereas an association is placed in a class with corporations. In line with the *Cambridge Loan & Bldg. Company* and other decisions of this Court, *e. g.* regarding the status of spouses in the community property states,* the petitioner's status under State law determines its taxable status under the Federal revenue act to be that of a trust.

Second and Third Reasons:

Section 801 (a) (2) provides that the term "corporation" shall include associations. The Board and the Court held that petitioner was an association. Petitioner contends that it was not an association, under applicable decisions of this Court, even though the Oklahoma law is held not to control its status.

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* *Poe* v. *Seaborn*, 282 U. S. 101; *Goodell* v. *Koch*, 282 U. S. 118; *Hopkins* v. *Bacon*, 282 U. S. 122; *Bender* v. *Pfaff*, 282 U. S. 127.

In 1919 this Court decided *Crocker* v. *Malley*, 249 U. S. 223. That case arose under the Income Tax Act of 1913, which taxed "every corporation, joint-stock company or association." There the trust owned paper manufacturing mills which were being operated by lessees. The function of the trustees was to collect the rents and income from the property, but they had broad discretion in handling the trust's affairs. They were required to handle the property and income for the benefit of the beneficiaries, but were not required to make annual distributions and could in fact reinvest the funds and postpone distribution for a period of 20 years, the term of the trust. The Court, speaking through Mr. Justice Holmes, held that the trust was not an association taxable as a corporation. The Court said:

> "There can be little doubt that in Massachusetts this arrangement would be held to create a trust and nothing more. 'The certificate holders * * * are in no way associated together * * *.'
> * * * * * * * * *
> "We perceive no ground for grouping the two—beneficiaries and trustees—together, in order to turn them into an association, by uniting their contrasted functions and powers, although they are in no proper sense associated. It seems to be an unnatural perversion of a well-known institution of law."

The trust in the *Crocker* case had broader powers than did petitioner. It could re-invest its funds and petitioner's trustees could not. It could accumulate indefinitely while petitioner had to distribute its funds monthly. The beneficiaries could change the compensation of the trustees and designate the successors in the case of a vacancy. No such powers existed in the beneficiaries of petitioner. The language of the Court there clearly indicates a recognition of the State's inherent right to control property rights and determine the legal status of its subjects for tax purposes in the absence of a clear intention in the law to classify them otherwise. The *Crocker* decision goes much farther than this Court is asked to go in the instant case.

In 1924 the Supreme Court decided the case of *Hecht* v. *Malley*, 265 U. S. 144, and three associated cases. All four cases involved trusts and the question was whether or not they were engaged in business so as to subject them to the excise tax provision (commonly called the capital stock tax law) of the Revenue Act of 1918. The law taxed corporations and associations alike upon the value of their capital stock if they were engaged in carrying on or doing business. The Court found that all four trusts were engaged in business and therefore were subject to the tax. One of the trusts was the trust involved in the *Crocker* case, *supra*, but the Court pointed out that it had been changed or reorganized so that it was now clearly engaged in business.

The last important decision of the Court on the taxing of trusts as corporations is *Morrissey* v. *Commissioner of Internal Revenue*, 296 U. S. 344, and associated cases. That case arose under the income tax provisions of the Revenue Acts of 1924 and 1926, the material parts of which are substantially the same as the provisions of the Revenue Act of 1934 here under consideration. The facts were that the trustees in 1921 made a declaration of trust of real estate, reserving the powers to purchase, encumber, sell, lease, and operate the property; to construct and operate golf courses, club houses, etc.; receive the rents, profits, and income; make loans and investments; make regulations; and generally manage the trust estate as if they were the absolute owners. There was no provision for current or periodical distribution of income to the beneficiaries.

After platting some of its land, selling lots, and constructing a golf course and club house, the *Morrissey* trust sold the property to a corporation for stock, but continued to operate it under lease until January, 1924. In the taxable years, its activities consisted of collecting installments of principal and interest on contracts of purchase, the receipt of interest on bank accounts and of fees on assignments by the holders of purchase contracts, the execution of conveyances to purchasers, the receipt of dividends on the stock of the incorporated club, and the distribution of moneys to its beneficiaries. The

trustees held from 16 to 29 per cent of the beneficial certificates.

The Court held that the *Morrissey* trust was an association taxable as a corporation. It said:

> "'Association' implies associates. It implies the entering into a joint enterprise, and, as the applicable regulation imports, *an enterprise for the transaction of business.*"

The owners of petitioner's beneficial interests did not "associate" themselves as conductors of a joint business enterprise. At the time of the creation of the trust, petitioner's trustees did not know who would become beneficiaries, and had no form of association with them. The trustees themselves did not purchase or own beneficial units. The certificate holders had nothing to do with the planning and creation of the trust, since it was formed before they purchased their shares. They were ignorant of the identity of the other certificate holders. (R. 62–65.) These facts negative any thought that there was a voluntary "association" between and among the certificate holders and the trustees.

Petitioner acquired a minority interest in an oil and gas lease which already had five producing wells which were being operated by the Westgate Oil Company under an operating agreement with the lessor. The oil and gas were sold directly to the pipe line companies by the Westgate Oil Company. (R. 62.) Petitioner acquired the right to receive its proportionate share of the proceeds from the sale of oil and gas, after its proportionate part of the expenses was deducted. It had no voice in the management or operation of the lease and could not say to whom the oil should be sold. It had only the right to see that its share of the proceeds was not dissipated. (R. 66.)

A statement of some of the activities which petitioner *did not* and *could not* do under the trust instrument serves to show that it did not carry on a business. Petitioner did not buy or sell property; it did not reinvest the proceeds from oil and gas sales; it did not drill any wells and did not own any drilling

machinery; it did not receive oil and gas as such and then resell it; it did not perform any act which entailed the exercise of business judgment in connection with the property in which it had an interest (App. 62–66). No power is given the trustees to purchase property; to sell trust property, unless they had the consent of two-thirds of the beneficiaries; to reinvest funds in their possession; to borrow money or make notes; to mortgage property; to make or renew leases; to repair, improve, or develop property. They were obliged to distribute all moneys which came into their possession, and could retain nothing except an amount to cover current expenses. Since they were without power to acquire any additional property, the powers given by the trust instrument could be exercised only with respect to the property conveyed by that instrument, and by the terms of the conveyance they had no voice in its management.

The mere collection and distribution of income, after paying the necessary carrying charges, does not constitute the carrying on of a business. *McCoach* v. *Minehill Rd. Co.*, 228 U. S. 295; *U. S.* v. *Emery, Bird, Thayer Realty Company*, 237 U. S. 28; *Higgins* v. *Com.*, 312 U. S. 212; *City Bank Farmers Trust Co.* v. *Com.*, 313 U. S. 121; *The Cleveland Trust Co., et al.* v. *Com.*, 115 F. 2d 481 (C.C.A., 6th).

It is well established that the owning of a *royalty* interest in an oil and gas property does not alone constitute the carrying on of a business. There is no difference between a royalty interest and a minority right to a share of the net proceeds from the working interest (the lessee's interest), when the owner of the interest has no voice in the management and operation of the lease, but simply receives a share of the net proceeds after the expenses of producing are paid. Such an interest is referred to as an over-riding royalty and such was petitioner's interest in the Westgate-Carey lease.

It has been shown that petitioner possessed only the right to receive a share of the proceeds from the oil and gas sales from the Westgate-Carey lease, after expenses were paid. The Westgate Oil Company did not operate the property as

agent for petitioner because petitioner had no control whatever over that company. (R. 66.)

The Board held, however (R. 27), that the Westgate Oil Company operated the lease for petitioner to the extent of petitioner's interest in the proceeds therefrom, and cited *Helvering* v. *Combs*, 296 U. S. 365. In that case the trustees acquired the whole interest in the lease except 8.5% of the oil and gas reserved by the lessor. An agreement was made with one Bailes to furnish some of the equipment and materials and to superintend the drilling of a well in return for 12% of the production. The trust paid for labor and materials not provided by Bailes. By that agreement the trustees employed Bailes as superintendent to do the drilling but he was under their direction and control. In effect they performed the drilling. That case furnishes no authority for the holding that the Westgate Oil Company operated the property for petitioner.

Thus it appears that petitioner was not an association and was not doing business, and therefore is not taxable as a corporation under the decisions of this Court.

CONCLUSION.

In view of the foregoing it is respectfully requested that the writ of certiorari be granted.

Respectfully submitted,

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APPENDIX.

REVENUE ACT OF 1934:

Sec. 22. GROSS INCOME (48 Stat. 686).

(a) General Definition.—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

* * * * * * * * *

(b) Exclusions from Gross Income.—The following items shall not be included in gross income and shall be exempt from taxation under this title:

* * * * * * * * *

Gifts, Bequests, and Devises.—The value of property acquired by gift, bequest, devise, or inheritance (but the income from such property shall be included in gross income);

Sec. 23. DEDUCTIONS FROM GROSS INCOME (48 Stat. 688).

In computing net income there shall be allowed as deductions:

* * * * * * * * *

(l) Depreciation.—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescense. * * *

(m) Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary.

* * * * * * *

Sec. 114. BASIS FOR DEPRECIATION AND DEPLETION (48 Stat. 710).

* * * * * * *

(b) Basis for Depletion.—

* * * * * * *

(3) Percentage Depletion for Oil and Gas Wells.—In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

Sec. 161. IMPOSITION OF TAX (48 Stat. 727).

(a) Application of Tax.—The taxes imposed by this title upon individuals shall apply to the income of estates or of any kind of property held in trust, including—

* * * * * * * *

(2) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of an infant which is to be held or distributed as the court may direct;

Sec. 162. NET INCOME (48 Stat. 728).

The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

* * * * * * * *

(b) There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the beneficiaries,

* * * * * * * *

Sec. 801. DEFINITIONS (48 Stat. 771).

(a) When used in this Act—

(1) The term "person" means an individual, a trust or estate, a partnership, or a corporation.

(2) The term "corporation" includes associations, joint-stock companies, and insurance companies.

OKLAHOMA STATUTES, 1931:

11,820. EXPRESS TRUSTS AUTHORIZED.

Express trusts may be created in real or personal property or both, with power in the trustee, or a majority of the trustees, if there be more than one, to receive title to, hold, buy, sell, exchange, transfer and convey real and personal property for the use of such trust; to take, receive, invest or disburse the receipts, earnings, rents, profits or returns from the trust estate; to carry on and conduct any lawful business designated in the instrument of trust, and generally to do any lawful act in relation to such trust property which any individual owning the same absolutely might do.

11,821. DECLARATION OF TRUST AND RECORDING DURATION.

No such express trust shall be valid unless created, first, by a written instrument subscribed by the grantor or grantors duly acknowledged, as conveyances of real estate or acknowledged and recorded in the office of the county clerk of each county wherein is situated any real estate conveyed to such trustee, as well as in the county where the principal property is located or business conducted; or, second, by a will duly executed, as required by the law of the state. Such express trusts shall be limited in the duration thereof either to a definite period of not to exceed twenty-one (21) years, or to the period of the life or lives of the beneficiary or beneficiaries thereof. The instrument creating the trust shall specify the period of duration thereof within the limitations herein provided.

11,822. SUCCESSION OF TRUSTEES.

Instruments creating express trusts may provide for succession to any trustee, in case of the death, resignation, removal, or incapacity of such trustee. In case of any such succession, the title to the trust property shall at once vest in the succeeding trustee.

11,823. LIABILITIES OF TRUSTEES AND BENEFICIARIES TO THIRD PERSONS.

Liabilities to third persons for any act, omission, or obligation of a trustee or trustees of an express trust when acting in such capacity shall extend to the whole of the trust estate held by such trustee or trustees, or so much thereof as may be necessary to discharge such liability, but no personal liability shall attach to the trustee or the beneficiaries of such trust for any such act, omission or liability.

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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 135

SECOND CAREY TRUST, AN EXPRESS TRUST, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 15–34) is reported at 41 B. T. A. 800. The opinion of the Court of Appeals (R. 95–101) is reported at 126 F. (2d) 526.

JURISDICTION

The judgment of the Court of Appeals was entered March 9, 1942. (R. 102.) Petition for a

writ of certiorari was filed June 9, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the taxpayer trust during the year 1934 was an association within the meaning of Section 801 (a) (2) of the Revenue Act of 1934, taxable as a corporation.

2. If the taxpayer was taxable as a corporation, then whether the Board erred in denying taxpayer's motions, filed after the Board had promulgated its findings of fact and opinion upon the issues tried before it, (a) for further hearing so that taxpayer might introduce proof upon issues suggested by taxpayer's pleadings, and upon which the taxpayer might have but did not offer proof at the trial; and, (b) for leave to amend its pleadings to set up new issues not theretofore raised by the pleadings and for a hearing upon such new issues.

STATUTES AND REGULATIONS INVOLVED

These will be found in the Appendix, *infra*, pp. 19–31.

STATEMENT

The facts found by the Board (R. 16–26) may be summarized as follows:

The organization, powers, and operations of the taxpayer.—Taxpayer was organized as an "express

trust" under Oklahoma law by W. E. Brown, A. J. Diffie and H. I. Shanks on January 19, 1934 (R. 16, 74). By the trust instrument (R. 73–84) Brown, Diffie and Shanks undertook, as trustees, to hold, manage and operate as necessary for the unit holders in the trust an undivided one-eighth of the seven-eighths working interest in a certain lease known as the Westgate-Carey lease, covering 73 acres in Oklahoma County, Oklahoma, and four oil and mining leases in other counties in Oklahoma. Taxpayer paid its grantors approximately $400,000 for the property (R. 16).

Taxpayer obtained the funds with which to purchase its properties from the sale of nonassessable units of beneficial interest of the par value of $100 each. There were 5,000 authorized units, which were sold for a total consideration of $500,000, and a net amount of $400,000. Registration was obtained with the Securities and Exchange Commission (R. 17).

Each unit owner received a "Certificate of Interest in 'Second Carey Trust,' " upon which was shown the owner's name and the number of beneficial units he owned (R. 17, 85). The owner of each unit was entitled to receive a one five-thousandth part of the distributable net income and proceeds of the trust property (R. 17–18, 77, 85). The certificates were transferable only on the books of the trust and provided that the certificate owner

should have no authority to transact any business for the trust and no interest in the specific property of the trust, nor any right to demand a division of the property, and that the certificate owner should not be personally liable for any debts, covenants, contracts or torts of the trust or its trustees (R. 18).

The trust instrument (R. 73–84) authorized the trustees (and their successors) to operate and manage the trust and conduct all its business (R. 18–19, 21); to receive, collect and distribute the income (R. 21); to sell all or any part of the trust property with the consent of the owners of two-thirds in amount of the units in the trust (R. 21); to deduct from the gross receipts all expenses of managing and operating the trust, including as compensation for themselves five percent of the net receipts from whatever source derived (R. 22, 79); and then to distribute the balance of the net receipts, less a small amount withheld to meet current expenses, ratably among the unit holders monthly (R. 80). Until all units were sold, however, the trustees were to be entitled in their own separate right to so much of the net income of the trust as was in proportion to the number of unsold beneficial units (R. 19–20, 77).

The trust instrument further provided that neither the trustees nor the unit owners should be personally liable for the obligations of the trust (R. 24, 81–82); required the trustees to keep ac-

curate records and accounts (R. 82); and authorized them to fill any vacancies in the trusteeship (R. 83). The trustees were directed to conduct all business and execute all instruments under the name of the trust and to elect one of their number as president, one as vice president, and one as secretary-treasurer (R. 18–19, 76). The trust instrument also provided that the trust might be terminated at any time, upon written direction of the owners of two-thirds in amount of the beneficial units, but otherwise should continue for a period of 20 years and then be liquidated (R. 21, 78).

It was provided that ownership of units of beneficial interest by any person or persons should not create any partnership between the trustees and any such person or persons, nor between or among the unit holders; that the trustees should have no authority to create a partnership between themselves and any other person, firm or corporation with reference to the trust estate; that the trustees should at all times have the sole and exclusive right to manage the business of the trust; and that no unit holder should ever have the right as such to interfere with the trustees' management or control (R. 22–23).

It was also provided that the death, insolvency or bankruptcy of any unit holder or the transfer of his interest in any way during the continuance of the trust should not operate as a dissolution or termination of the trust, or have any effect whatever

on the trust estate (R. 23); and that the trust could be modified or amended by the trustees acting with the written consent of the holders of two-thirds in amount of the units (R. 24, 83).

On January 19, 1934, the Westgate-Carey lease was a producing lease and was being operated by the Westgate Oil Company. Additional wells were drilled on the property in 1934 (R. 16–17). As the owner of a working interest in the lease, the taxpayer became obligated to pay to the Westgate Oil Company its proportion of the expense of operating the oil wells on the lease and the cost of the new development. Taxpayer had a representative checking each bill as it came in (R. 17). The oil which was produced was sold on the premises to pipeline purchasing companies and taxpayer became entitled to its proportionate share of the proceeds (R. 17).

Taxpayer did not develop any of the four leases which it obtained along with the undivided one-eighth of the seven-eighths working interest in the Westgate-Carey lease, but allowed them to lapse.[1] (R. 16, 64).

Taxpayer has never purchased or acquired any other leases or lands than those described in the declaration of trust (R. 24). As the owner of its undivided one-eighth of the seven-eighths working

[1] The evidence is in conflict as to whether taxpayer paid rentals on the four leases (R. 64, 66).

interest in the Westgate-Carey lease it owns a like interest in the physical properties, including the operating equipment on the lease (R. 24).

There was some evidence before the Board (R. 33, 68) that, during 1934, the trustees permitted the trust to retain for distribution to the unit holders approximately $36,882.84 of income otherwise apportionable to unsold units of beneficial interest in accordance with the fifth paragraph of the trust instrument (R. 19–20, 77).

The trust did not set up on its books any capital or surplus accounts. Distributions to beneficiaries were made from the net receipts from the sale of oil and gas (R. 24, 67).

The returns filed, the issues before the Board, and the petitions for further hearing and to amend.— Taxpayer filed an income tax return for 1934 as a trust on form 1040, showing a net loss of $7,552.79. Among the deductions from gross income claimed were "Distributions to unit holders $55,986.00" and "depletion and depreciation $35,466.05." Taxpayer did not file with its return information data on form O in support of the claimed deduction for depletion and depreciation, as required by the Commissioner's regulations (R. 24–25).

Taxpayer did not file a capital stock tax return for the period ended June 30, 1934, nor has it made a declaration of the value of its capital for capital stock tax purposes. On October 1, 1937, a capital

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stock tax for that period, based on valuation of $500,000, and additional tax of 25 per cent was assessed, and taxpayer has paid such assessed taxes (R. 25–26).

In computing the deficiency in income and excess profits taxes for which he sent the taxpayer notice of deficiency (R. 9–12) the Commissioner held taxpayer to be an association taxable as a corporation, disallowed the claimed deduction of $55,986 as distributions to unit holders upon the ground that they constituted dividends, and also disallowed the deduction of $35,466.05 for depletion and depreciation for lack of evidence to substantiate the deduction (R. 12, 25).

Taxpayer filed a petition before the Board of Tax Appeals in which it alleged that it was not an association within the meaning of the Revenue Act, and in the alternative, if it should be held taxable as an association, that the computation of taxable net income made by the Commissioner was erroneous (1) for the reason that the computation was "based on accounts as recorded by a fiduciary in accounting for net cash receipts from whatever source derived, and which receipts do not constitute taxable net income," (2) because no allowance was made for depletion or depreciation, and (3) because no deduction was allowed, in the computation of excess profits tax, for 12½ percent of a declared value of capital (R. 4–5).

At the hearing before the Board taxpayer's counsel introduced evidence upon the issue whether or

not taxpayer was an association taxable as a corporation. No evidence was submitted from which either cost depletion or a deduction for depreciation could be computed. The Board held that the taxpayer was an association taxable as a corporation (R. 29); that, lacking evidence to show that taxpayer was entitled to depreciation or to depletion based on cost, it could allow taxpayer percentage depletion but not cost depletion and no depreciation (R. 30); and that taxpayer was entitled to a deduction of 12½ percent of an adjusted declared value of $500,000 for its capital stock in the computation of its excess profits tax (R. 33). The latter holding resulted in a determination that no excess profits tax was due from the taxpayer, the other holdings in a substantial reduction in the income tax which the Commissioner had proposed and determined (R. 39).

Some twenty-nine days after the Board promulgated its findings and opinion, taxpayer filed a "Motion for Rehearing, Re-Consideration, and Further Hearing" (R. 34–39), asking for reconsideration of the decision that taxpayer was an association and, in the alternative, if the Board should adhere to that portion of its decision, then for a rehearing so that taxpayer might present evidence upon the alternative issues raised by taxpayer's petition with respect to depletion, depreciation and valuation of taxpayer's capital stock for excess profits tax purposes, upon which taxpayer

had submitted practically no evidence at the trial. The Board denied this motion May 9, 1940 (R. 39). On July 19, 1940, the Board entered its decision pursuant to its findings of fact and opinion (R. 39).

On August 19, 1940, taxpayer filed another motion with the Board captioned "Motion to Vacate Board's Report and Decision; to Grant a New Trial or a Further Hearing; to Make Additional Findings; and to Allow Amendments to the Petition" (R. 40–49). In this motion taxpayer admitted that its case was tried "solely on the one ground that petitioner is not taxable as an association. No evidence was introduced to support the other assignments of error * * *" (R. 40). By its new motion taxpayer sought leave to renew its contention that it was not an association, leave to present evidence that it was entitled to a deduction for depreciation and to depletion based upon cost (rather than to percentage depletion) and the amount of the depreciation and depletion desired, and leave to amend its petition before the Board to ask for still further adjustments. The further adjustments desired were (1) the elimination from taxpayer's income of $36,882.84 in receipts from the sale of oil, which taxpayer asserted was capital contributed to it by the trustees as individuals, and (2) the deduction of $19,575.20 from income as development costs (R. 51–52). The Board denied this motion (R. 49).

The Court of Appeals affirmed the decision of the Board upon all issues.

ARGUMENT

A

The court below correctly ruled that the petitioner was taxable as an association rather than as a pure trust. The decision is in accordance with the decisions of this Court and there is no occasion for further review.

Petitioner's leading contention is that it is an "express trust" under Oklahoma law and that it therefore cannot be classified as an association taxable as a corporation under the Federal revenue acts. It may be conceded, *arguendo,* that petitioner is an "express trust" under Oklahoma statutes and decisions (see Sections 11820, 12369, Okla. Stats., Vol. 2, 1931; *State* v. *Prairie Cotton Oil Co.,* 180 Okla. 608); but this Court has squarely held that whether an organization is an association under the revenue acts does not depend upon its status under local law. *Burk-Waggoner Assn.* v. *Hopkins,* 269 U. S. 110. Compare *Morgan* v. *Commissioner,* 309 U. S. 78, 80–81; *Heiner* v. *Mellon,* 304 U. S. 271, 279; *Lyeth* v. *Hoey,* 305 U. S. 188, 193; *Burnet* v. *Harmel,* 287 U. S. 103, 110; *Weiss* v. *Wiener,* 279 U. S. 333, 337. The pertinent inquiry therefore is whether Congress intended the term "association," used in the federal statute, to include such an organization as the taxpayer.

The latter had all those features which ordinarily characterize such an organization: associates com-

bined in a business enterprise;[2] centralized management of the enterprise without termination or interruption by death of either a beneficial owner or a trustee or by changes in the ownership in interests; transferability of certificates; and limitation of the personal liability. It was, therefore, an "association" within the meaning of Section 801 (a) (2) of the Revenue Act of 1934, and taxable as a corporation. *Morrissey* v. *Commissioner*, 296 U. S. 344; *Helvering* v. *Combs*, 296 U. S. 365; *Swanson* v. *Commissioner*, 296 U. S. 362; *Helvering* v. *Coleman-Gilbert*, 296 U. S. 369; *Keating-Snyder Trust* v. *Commissioner*, 126 F. (2d) 860 (C. C. A. 5th); *Commissioner* v. *Fortney Oil Co., etc.*, 125 F. (2d) 995 (C. C. A. 6th); *United States* v. *Trust No. B. I. 35, etc.*, 107 F. (2d) 22 (C. C. A. 9th).

Taxpayer was not organized to liquidate property, but solely to provide a medium for the conduct of a business and sharing its gains. The purchasers of beneficial interest contributed their cash for that purpose. Their objective could be accomplished only by operation of the leases or leasehold interests or by the sale of the leases or interests therein. Either mode of realizing upon their interests in the leases contemplated activity of a business nature by the trustees. They and their

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[2] Lack of control over the trustees by the associates is not a decisive factor. *Morrissey* v. *Commissioner*, 296 U. S. 344, 355; *Helvering* v. *Combs*, 296 U. S. 365, 368; *Hecht* v. *Malley*, 265 U. S. 144. Moreover, the owners of two-thirds in amount of the units could repeal, modify or amend the trust (R. 83).

organization are "not at liberty [now] to say that their purpose was other or narrower than that which they formally set forth in the instrument under which their activities were conducted." *Helvering* v. *Coleman-Gilbert, supra,* p. 374. To like effect see *Keating-Snyder Trust* v. *Commissioner, supra; Kettleman Hills R. S. No. 1* v. *Commissioner,* 116 F. (2d) 382 (C. C. A. 9th), certiorari denied, 313 U. S. 582; *Sears* v. *Hassett,* 111 F. (2d) 961 (C. C. A. 1st). Taxpayer's assertion (Pet. 8) that the trustees had no power to develop the four leases disregards the terms of the trust instrument. (See R. 74, 76, 78, 82.) The fact that at the time of the creation of the trust the trustees did not know who would become beneficiaries is without significance. Those who purchased became none the less associates in the enterprise.

There is no conflict with *United States* v. *Cambridge Loan & Bldg. Co.,* 278 U. S. 55. The question there was one of statutory interpretation of the term "domestic building and loan associations" used in the Revenue Acts of 1918 and 1921. The Court held the term used in the sense in which the Treasury Regulations originally interpreted it, as meaning organizations which were building and loan associations under state law. The term "association" appearing in the federal act is, on the other hand, a term used in its ordinary sense as an organization analogous to and resembling but distinguished from a corporation. *Morrissey* v. *Commissioner, supra.* And the decision of this Court

in the *Burk-Waggoner* case, *supra,* establishes the result that state law is not determinative here.

Nor is the decision below in conflict with *Higgins* v. *Commissioner,* 312 U. S. 212, or *City Bank Farmers Trust Co.* v. *Helvering,* 313 U. S. 121. Both those cases arose under altogether different sections of the Revenue Acts; neither raised or involved the question whether the particular taxpayer was an "association." Nor is there conflict with *Cleveland Trust Co.* v. *Commissioner,* 115 F. (2d) 481 (C. C. A. 6th), certiorari denied, 312 U. S. 704, which is distinguishable upon its facts. Moreover, later decisions of the same court have held that oil trusts quite similar to the trust here involved are associations. See *Nashville Trust Co.* v. *Cotros,* 120 F. (2d) 157 (C. C. A. 6th), certiorari denied, 314 U. S. 680; *Commissioner* v. *Fortney Oil Co., supra.*

B

Taxpayer tried but one issue before the Board. As its counsel has admitted "no evidence was introduced to support the other assignments of error" (R. 40). In short, no evidence was introduced to prove the depreciation, if any, which taxpayer might have claimed, the depletion based on cost to which taxpayer might be entitled, if depletion based on cost of its deletable assets would exceed percentage depletion, or that in computing its excess profits tax the taxpayer was entitled to the use of any particular figure for the declared value of its stock. In the circumstances the Board of Tax Appeals

could do no more for the taxpayer on its alternative issues than to deny it a deduction for depreciation (R. 31), allow it percentage depletion (R. 31) and in addition a credit for excess profits tax purposes of 12½ per cent of $500,000 (R. 33). The taxpayer had sold its certificates of beneficial interest for $500,000 (R. 17) and in 1937, when the Commissioner assessed a capital stock tax against the taxpayer for the year ended June 30, 1934, that tax had been based on a capital stock valuation of $500,000 (R. 26). Thus the Board did the most it could for the taxpayer, on the record made at the trial.

Taxpayer's motions for further trial (R. 14, 34–39, 40–49) to prove the issues which it had not proved or attempted to prove at the trial,[3] and for leave to set up new and additional issues were, of course, addressed to the Board's discretion. *Bankers Pocahontas Coal Co.* v. *Burnet,* 287 U. S. 308, 312–313; *Skenandoa Rayon Corp.* v. *Commissioner,* 122 F. (2d) 268 (C. C. A. 2d). As the Board observed (R. 30), in denying taxpayer's first very general and noninformatory motion, "to grant the motion * * * would be tantamount to permitting the issues to be tried piecemeal after they were submitted as a whole. This we will not do." The denial of a rehearing and of further trial, in such circumstances, is not an abuse of discretion by the

[3] Indeed it is doubtful whether its allegations really raised those issues. See R. 4–5, 7.

Board. *Bankers Pocahontas Coal Co.* v. *Burnet, supra; Skenandoa Rayon Corp.* v. *Commissioner, supra; Holderness* v. *Commissioner,* 86 F. (2d) 137, 139 (C. C. A. 4th); *Commissioner* v. *Fortney Oil Co., supra; Steele-Wedeles Co.* v. *Commissioner,* 63 F. (2d) 541, 543 (C. C. A. 7th). See also *Rhodes* v. *Commissioner,* 111 F. (2d) 53, 57 (C. C. A. 4th); *Freeman-Hampton Oil Corp.* v. *Commissioner,* 65 F. (2d) 456, 457 (C. C. A. 5th); *O'Rear* v. *Commissioner,* 80 F. (2d) 473, 475–476 (C. C. A. 6th).

The taxpayer's final motion (R. 40–49) attempted to renew all the previous motions for rehearing and to set up new issues. Although an attempt to raise new issues was disavowed (R. 51), the proposed amendments to the petition, nevertheless alleged for the first time in this litigation (1) that $36,882.84 of the 1934 receipts "from the proportionate part of the trust property represented by unsold units" were not property of the taxpayer, but of its trustees, who contributed the $36,882.84 to taxpayer's capital in 1934, and (2) that taxpayer had $19,575.20 of development costs in 1934. Taxpayer alleged, in its proposed amendments, that the $36,882.84 was not income to it and that the $19,575.20 was a deductible expense (See R. 51–52). Taxpayer's attempt thus to inject new issues into the case was, of course, addressed to the discretion of the Board and was properly denied. *Bankers Pocahontas Coal Co.* v. *Burnet, supra,* p. 313, and other cases cited above. The Court of Appeals did not err in affirming the Board.

The court below denied taxpayer any relief with respect to the $36,882.84 item for the compelling reason that "the petitioner has raised no issue as to this in the pleadings" (R. 100). For purposes of further remarks the court then assumed that the $36,882.84 was a "gratuity" to the taxpayer from its trustees (R. 100).[4] Accordingly, there cannot be any conflict on this issue with *Rice, Barton & Fales* v. *Commissioner*, 41 F. (2d) 339 (C. C. A. 1st), and *American Dental Co.* v. *Commissioner*, (C. C. A. 7th), decided May 15, 1942, not yet officially reported but found in Prentice-Hall 1942, Vol. 4, par. 63,113, which in any event present different facts and issues.

Nor is the decision below in conflict with *Underwood* v. *Commissioner*, 56 F. (2d) 67 (C. C. A. 4th), or with *Ray W. Torrey Co.* v. *Commissioner*, 84 F. (2d) 659 (C. C. A. 6th). The trial in the *Underwood* case had proceeded upon an erroneous theory, which was shared by both parties, and in the course of the trial taxpayer proved his right to but did not prove the amount of the permissible

[4] We do not believe that the record justified the assumption. The $36,882.84 represented proceeds of the sale of oil and gas from the one-eighth of the seven-eighths working interest in the Westgate-Carey lease (R. 24, 67, 68). As such it constituted a part of the gross income of the taxpayer, the owner of the interest. Cf. *Helvering* v. *Horst*, 311 U. S. 112; *Anderson* v. *Helvering*, 310 U. S. 404, 408; *T. K. Harris Co.* v. *Commissioner*, 112 F. (2d) 76 (C. C. A. 6th); *Chicago, R. I. & P. Ry. Co.* v. *Commissioner*, 47 F. (2d) 990 (C. C. A. 7th), certiorari denied, 284 U. S. 618.

deduction. In the case at bar Government counsel objected from the outset to a split hearing (R. 61). In the *Torrey* case the taxpayer had alleged that it was entitled to file its returns on the installment basis and had proved its right to deductions on that basis but not the amount of the proper deductions. In addition the Board had lost some of the documentary evidence submitted at the trial. The Circuit Court of Appeals, in the particular situations, reversed and remanded the cases for further hearing. No such situation exists here. More nearly in point are the later decisions of the same courts in *Holderness* v. *Commissioner, supra,* p. 139; *Rhodes* v. *Commissioner, supra,* p. 57; *O'Rear* v. *Commissioner, supra,* pp. 475–476; *Commissioner* v. *Fortney Oil Co., supra,* next to last paragraph.

CONCLUSION

The decision below is in accord with applicable decisions of this Court. The Court of Appeals did not err in refusing to order a rehearing and further trial before the Board of Tax Appeals. There is no conflict of decisions. It is respectfully submitted that the petition should be denied.

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JUNE 1942.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680.

TITLE I—INCOME TAX

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *

* * * * *

(1) *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * * (For percentage depletion allowable under this subsection, see section 114 (b), (3) and (4).)

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * *

SEC. 54. RECORDS AND SPECIAL RETURNS.

(a) *By Taxpayer.*—Every person liable to any tax imposed by this title or for the collection thereof, shall keep such records, render under oath such statements, make such returns, and comply with such rules and regulations, as the Commissioner, with the approval of the Secretary, may from time to time prescribe.

(b) *To Determine Liability to Tax.*—Whenever in the judgment of the Commissioner necessary he may require any person,

by notice served upon him, to make a return, render under oath such statements, or keep such records, as the Commissioner deems sufficient to show whether or not such person is liable to tax under this title.

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect to any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property.

(b) *Basis for Depletion.*—

(1) *General Rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

* * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if

computed without reference to this paragraph.

* * * * *

TITLE VI—GENERAL PROVISIONS

SEC. 801. DEFINITIONS.

(a) When used in this Act—

(1) The term "person" means an individual, a trust or estate, a partnership, or a corporation.

(2) The term "corporation" includes associations, joint-stock companies, and insurance companies.

(3) The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this Act, a trust or estate or a corporation; and the term "partner" includes a member in such a syndicate, group, pool, joint venture, or organization.

* * * * *

(8) The term "stock" includes the share in an association, joint-stock company, or insurance company.

(9) The term "shareholder" includes a member in an association, joint-stock company, or insurance company.

* * * * *

The Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 23(m)–12. *Statement to be attached to return when valuation, depletion, or depreciation of mineral property is claimed.*— (a) Except as provided in article 23(m)–13, there shall be attached to the return of every

taxpayer asserting a value for any mineral property as of a specific date or claiming a deduction for depletion or depreciation a statement setting forth with respect to each mineral property (including oil and gas property):

(1) The name, description, location, and identifying number, if any, of the property;

(2) Whether taxpayer is a fee owner, lessor, or lessee;

(3) The date of acquisition and, if under lease, the exact terms and date of expiration of the lease;

(4) The cost of the property, stating the amount paid to each vendor, with his name and address;

(5) The date as of which the property is valued, if a valuation is necessary to establish the basis as provided by section 113(a);

(6) The value of the property on that date with a statement of the precise method by which it was determined;

(7) An allocation of the cost or value as between the mineral deposit and other assets as plant, equipment, or the surface of the land for purposes other than mineral production;

(8) The estimated number of units of each kind of mineral at the end of the taxable year, and also at the date of acquisition, if acquired during the taxable year or at the date as of which any valuation is made, together with an explanation of the method used in the estimation, the name and address of the person making the estimate, and an average analysis which will indicate the quality of the mineral valued, including the grade or gravity in the case of oil;

(9) The number of units sold and the number of units for which payment was re-

ceived during the year for which the return is made (in the case of newly developed oil and gas properties it is desirable that this information be furnished by months);

(10) The gross amount received from the sale of mineral;

(11) The amount of depreciation for the taxable year and the amount of depletion for the taxable year computed without reference to percentage depletion or discovery value;

(12) The amounts of depletion and depreciation, stated separately, which for each and every prior year (A) were allowed, (B) were allowable, and (C) would have been allowable without reference to percentage depletion or discovery value; and

(13) Any other data which will be helpful in determining the reasonableness of the valuation asserted or of the deduction claimed.

(b) To the return of every taxpayer claiming a deduction for depletion in respect of (1) property in which he owns a fractional interest only, or (2) a leasehold, or (3) property subject to lease, there shall also be attached a statement setting forth the fraction of the gross production to which the taxpayer is entitled, the name and address and the precise nature of the holding of each person interested in the property, and, in the case of a lessor, whether the lease involved was still in effect at the close of the taxable year, and, if not, when it was terminated and for what reason, and whether the lessor repossessed the property. Any taxpayer who is the assignor of a lease with respect to any property, or the holder of an interest purporting to be an overriding royalty interest, or of any interest other than that of a lessor

or an operating lessee, and who claims depletion with respect to such property or interest, shall state the exact nature of the interest held and shall furnish a certified copy of the instrument or instruments by which it was acquired.

(c) In the case of oil and gas properties the statement attached to the return shall contain, in addition to the foregoing, the following information with respect to each property:

(1) The number of acres of producing oil or gas land and, if additional acreage is claimed to be proven, the amount of such acreage and the reasons for believing it to be proven;

(2) The number of wells producing at the beginning and end of the taxable year;

(3) The date of completion of wells finished during the taxable year;

(4) The date of abandonment of all wells abandoned during the taxable year;

(5) A property map showing the location of the property and of the producing and abandoned wells, dry holes, and proven oil and gas lands (the map should show depth, initial production, and date of completion of each well, to the extent that such data are available);

(6) The number of pay sands and average thickness of each pay sand or zone on the property;

(7) The average depth to the top of each of the different pay sands;

(8) Annual production of the tract or of the individual wells, if the latter information is available, from the beginning of its productivity to the end of the taxable year, the average number of wells producing during each year, and the initial daily production

of each well (the extent to which oil or gas is used for fuel on the property should be stated with reasonable accuracy);

(9) All available data regarding change in operating conditions, such as unit operation, proration, flooding, use of air-gas lift, vacuum, shooting, etc., which have a direct effect on the production of the property; and

(10) Available geological information having a probable bearing on the oil and gas content; information with respect to edge-water, water drive, bottom hole pressures, oil-gas ratio, porosity of reservoir rock, percentage of recovery, expected date of cessation of natural flow, decline in estimated potential, and characteristics similar to characteristics of other known fields.

(d) All of the foregoing information must be furnished under oath, should be summarized, and may be included in a single affidavit.

(e) Any of the information required by this article which has been previously filed by the taxpayer need not be filed again but the statement attached to the return must indicate clearly when and in what form the information was previously filed. When a taxpayer has filed adequate maps with the Commissioner he may be relieved of filing further maps of the same properties, provided all additional information necessary for keeping the maps up to date is filed each year. This includes records of dry holes, as well as producing wells, together with logs, depth and thickness of sands, location of new wells, etc.

ART. 23 (m)-13. *Statement to be attached to return when depletion is claimed on percentage basis.*—(a) There shall be attached to the return of every taxpayer who claims

depletion of oil and gas wells under section 114 (b) (3) and article 23 (m)–4, or depletion of coal mines, metal mines, or sulphur mines or deposits under section 114 (b) (4) and article 23 (m)–5, a statement containing the following information with respect to every property for which percentage depletion is allowable:

(1) All data necessary for the determination of the "gross income from the property" as defined in paragraph (g) of article 23 (m)–1, including the amounts paid to lessors as rents or royalties, the amounts paid to holders of other interests in the mineral property, and the price per unit at which royalties were paid;

(2) All additional data necessary for the determination of the "net income of the taxpayer (computed without allowance for depletion) from the property" as defined in paragraph (h) of article 23 (m)–1; and

(3) The information required by paragraphs (a) (1), (a) (2), (a) (3), and (b) of article 23 (m)–12. The other information required by article 23 (m)–12 shall also be furnished if necessary in determining the gain or loss from the sale or other disposition of the property during the taxable year or if a valuation of the property is necessary for any purpose. The taxpayer may find it desirable to furnish such other information in all cases.

(b) All of the foregoing information shall be furnished under oath, should be summarized, and may be included in a single affidavit.

* * * * *

ART. 801–1. *Classification of taxables.*— For the purpose of taxation the Act makes its own classifications and prescribes its own

standards of classification. Local law is of no importance in this connection. Thus a trust may be classed as a trust or as an association (and, therefore, as a corporation), depending upon its nature or its activities. (See article 801–3.) The term "partnership" is not limited to the common law meaning of partnership, but is broader in its scope and includes groups not commonly called partnerships. (See article 801–4.) The term "corporation" is not limited to the artificial entity usually known as a corporation, but includes also an association, a trust classed as an association because of its nature or its activities, a joint-stock company, an insurance company, and certain kinds of partnerships. (See articles 801–2 and 801–4.) The definitions, terms, and classifications, as set forth in section 801, shall have the same respective meaning and scope in these regulations.

ART. 801–2. *Association.*—The term "association" is not used in the Act in any narrow or technical sense. It includes any organization, created for the transaction of designated affairs, or the attainment of some object, which, like a corporation, continues notwithstanding that its members or participants change, and the affairs of which, like corporate affairs, are conducted by a single individual, a committee, a board, or some other group, acting in a representative capacity. It is immaterial whether such organization is created by an agreement, a declaration of trust, a statute, or otherwise. It includes a voluntary association, a joint-stock association or company, a "business" trust, a "Massachusetts" trust, a "common law" trust, an "investment" trust (whether of the fixed or the management type), an

interinsurance exchange operating through an attorney in fact, a partnership association, and any other type of organization (by whatever name known) which is not, within the meaning of the Act, a trust or an estate, or a partnership. If the conduct of the affairs of a corporation continues after the expiration of its charter, or the termination of its existence, it becomes an association.

ART. 801–3. *Association distinguished from trust.*—The term "trust," as used in the Act, refers to an ordinary trust, namely, one created by will or by declaration of the trustees or the grantor, the trustees of which take title to the property for the purpose of protecting or conserving it as customarily required under the ordinary rules applied in chancery and probate courts. The beneficiaries of such a trust generally do no more than accept the benefits thereof and are not the voluntary planners or creators of the trust arrangement. Even though the beneficiaries do create such a trust, it is ordinarily done to conserve the trust property without undertaking any activity not strictly necessary to the attainment of that object.

As distinguished from the ordinary trust described in the preceding paragraph is an arrangement whereby the legal title to the property is conveyed to trustees (or a trustee) who, under a declaration or agreement of trust, hold and manage the property with a view to income or profit for the benefit of beneficiaries. Such an arrangement is designed (whether expressly or otherwise) to afford a medium whereby an income or profit-seeking activity may be carried on through a substitute for an organization such as a voluntary association or a joint-stock company or a corporation, thus obtaining

the advantages of those forms of organization without their disadvantages.

If a trust is an undertaking or arrangement conducted for income or profit, the capital or property of the trust being supplied by the beneficiaries, and if the trustees or other designated persons are, in effect, the managers of the undertaking or arrangement, whether the beneficiaries do or do not appoint or control them, the beneficiaries are to be treated as voluntarily joining or cooperating with each other in the trust, just as do members of an association, and the undertaking or arrangement is deemed to be an association classifed by the Act as a corporation.

By means of such a trust the disadvantages of an ordinary partnership are avoided, and the trust form affords the advantages of unity of management and continuity of existence which are characteristic of both associations and corporations. This trust form also affords the advantages of capacity, as a unit, to acquire, hold, and dispose of property and the ability to sue and be sued by strangers or members, which are characteristic of a corporation; and also frequently affords the limitation of liability and other advantages characteristic of a corporation. These advantages which the trust form provides are frequently referred to as resemblance to the general form, mode of procedure, or effectiveness in action, of an association or a corporation, or as "quasi-corporate form." The effectiveness in action in the case of a trust or of a corporation does not depend upon technical arrangements or devices such as the appointment or election of a president, secretary, treasurer, or other "officer," the use of a "seal," the

issuance of certificates to the beneficiaries, the holding of meetings by managers or beneficiaries, the use of a "charter" or "by-laws," the existence of "control" by the beneficiaries over the affairs of the organization, or upon other minor elements. They serve to emphasize the fact that an organization possessing them should be treated as a corporation, but they are not essential to such classification, for the fundamental benefits enjoyed by a corporation, as outlined above, are attained, in the case of a trust, by the use of the trust form *itself*. The Act disregards the technical distinction between a trust agreement (or declaration) and ordinary articles of association or a corporate charter, and all other differences of detail. It treats such a trust according to its essential nature, namely, as an association. This is true whether the beneficiaries form the trust or, by purchase or otherwise, acquire an interest in an existing trust.

The mere size or amount of capital invested in the trust is of no importance. Sometimes the activity of the trust is a small venture or enterprise, such as the division and sale of a parcel of land, the erection of a building, or the care and rental of an office building or apartment house; sometimes the activity is a trade or business on a much larger scale. The distinction is that between the activity or purpose for which an ordinary strict trust of the traditional type would be created, and the activity or purpose for which a corporation for profit might have been formed.

U. S. GOVERNMENT PRINTING OFFICE: 1942